THE LIABILITY OF CORPORATIONS ON CONTRACTS MADE BY PROMOTERS.

THE law is settled to the effect that an agreement entered into between a third person and a promoter, prior to the existence of the corporation, is not binding upon it, although made on account of the corporation and with the expectation that it will be liable. It is immaterial whether the agreement in question is in the name of the prospective corporation or that of the promoter. It is an equally unquestioned rule that, under certain circumstances, the corporation may become liable on terms substantially the same as those embodied in the agreement antedating the corporate existence. The purpose of this article is to consider the legal principles on which this liability rests.

For the sake of clearness, it is advisable to refer at the outset to a certain class of cases in which corporate liability exists. Though the principles involved are not properly within the scope of the present discussion, the tendency to confuse the basis of liability in those cases with cases covered here makes it necessary to point out briefly the theory on which those decisions proceed.

In many jurisdictions statutes make the corporation liable for certain expenses attending the organization and promotion of the company; more commonly the charter or the deed of settlement makes similar provisions.[1] Where such is the case, persons performing the services provided for in reliance upon the provisions may recover against the corporation when formed, the remedy being statutory.[2]

When the promoter has made a contract with a third person, the corporation may become a party to it by novation. It is obvious that the doctrine involved here is not peculiar to promoters, but extends to all contracts dealing with subject-matter within the scope of corporate power. Neither is it material at what time the contract was entered into with reference to the corporate existence.

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[1] Lindley, Companies, 6th ed., 196.

[2] Scott *v.* Lord Ebury, L. R. 2 C. P. 254; Lindley, Companies *supra.*

The corporation may also obtain rights under a contract by means of an assignment from the promoter or other parties.[1] Here, again, it is of no consequence whether the contract is with a promoter or not, and the time when it is made is equally immaterial.

A class of cases also exists in which the corporation is liable on the theory that a trust fund has been created by the corporation for the benefit of third persons, as a result of an agreement between the promoter and the corporation. In Touche *v.* Metropolitan Ry. Warehousing Co.,[2] the plaintiff was allowed to recover in equity on the theory that the corporation had made the promoter trustee of the sum in question. The decision has been doubted, as to the propriety of the finding that a trust relation existed under the facts in evidence,[3] although the principle is admitted that a trust may be created in favor of a third person by virtue of an agreement between the corporation and the promoter. In those jurisdictions where the real party in interest is permitted to sue, the third party may frequently have a remedy against the corporation, as a result of a provision for payment contained in a valid contract between the promoter and the corporation.

These exceptional cases being disposed of, it is now possible to take up the cases, which are the immediate object of this discussion, where an agreement has been entered into between a promoter and a third person, on which it is now proposed to hold the corporation liable. The common form of statement is that a corporation, by ratification or adoption, becomes liable on contracts made by a promoter on its account, prior to organization.[4] This statement, as far as it involves any theory of ratification, is clearly incorrect if taken literally, and repugnant alike to principle and to the great weight of authority.[5] Ratification is possible only where a contract is made by a person purporting to act for an existing principal, who is capable of making the contract himself at the time it is entered into. Clearly the doctrine can have no application in the class of cases discussed here, since the alleged principal is non-existent when the contract is made. Furthermore, the

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[1] Werdeman *v.* Soc. Gen'l D. Elec., 19 Ch. D. 250.

[2] L. P. C. A. Cas. 671.

[3] Gandy *v.* Gandy, 30 Ch. D. 57; *In re* Empress Engineering Co., 16 Ch. D. 125.

[4] Stanton *v.* New York, etc., Ry. Co., 59 Conn. 272; Spiller *v.* Paris Skating Rink Co., 7 Ch. D. 368.

[5] *In re* Empress Engineering Co., 16 Ch. D. 125.

promoter is not an agent in any proper sense of that term. His activities are confined to the promotion and organization of the corporation, and cease when the organization is complete. It is evident that the principles of agency will not serve in the solution of the question. The meaning of the term *adoption*, usually coupled with ratification as an alternative, by means of which the corporation may become liable, is somewhat obscure as used by the courts in this connection. It has been defined "to take or receive as one's own that with reference to which there existed no prior relation, colorable or otherwise."[1] With many courts the meaning is apparently the same as ratification. Properly it can be regarded only as a synonym of acceptance.[2]

The point of departure in the discussion, as far as the English cases are concerned, is a group of cases decided by Lord Cottingham.[3] Of these, Edwards *v.* Grand Junction Ry. Co. is the most frequently cited, on account of the full discussion by the court. The importance of the case justifies a somewhat complete statement.

The bill prayed an injunction restraining the defendant company from proceeding in violation of an agreement made by the projectors of the defendant company with the plaintiffs, by the terms of which the plaintiffs were to withdraw all opposition to the granting of a charter to the proposed company, in return for which the projectors promised to have inserted in the company's articles certain amendments respecting the width of a bridge over the turnpike operated by the plaintiffs. The corporation when formed proceeded to build the road, ignoring entirely the agreement with the projectors. The agreement in question was never acted upon by the corporation. Lord Cottingham, in granting the injunction, stated that the corporation stands in the place of the projectors and succeeds to their rights and must assume their liabilities. In reply to the argument that no undertaking by the corporation is shown, the court said: "The question is not whether there can be a binding contract at law, but whether the court will permit the company to use its powers under the act in direct opposition to the arrangement made with the trustees prior to the act, upon the faith of which they were permitted to obtain powers."

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[1] Schreyer *v.* Turner Flouring Co., 29 Ore. 1.

[2] Lindley, Companies, 6th ed., 232.

[3] Edwards *v.* Grand Junction Ry. Co., 1 Myl. & Cr. 650; Stanley *v.* Chester & B. Ry. Co., 9 Sim. 264; Webb *v.* L. & P. Ry. Co., 9 Hare 129.

The decision, which was followed in two later decisions[1] by the same judge, goes much further than any other case, both in its facts and conclusion, since the company had not in any way indicated an assent to the agreement of the projectors, making it impossible to invoke any doctrine of ratification or adoption.

The acceptance of the charter cannot be regarded as such an assent, since the company derives its charter from Parliament and not from the plaintiff, hence its enjoyment cannot be regarded as inconsistent with the defendant's claim of non-liability on the agreement.[2]

The decision has been repeatedly criticised in the later English decisions, and while not in terms overruled, it is seriously discredited as a precedent.[3] The decision is criticised for assuming any identity between the projectors and the corporation itself. If the identity exists, then the conclusion that the company is liable follows without question, as it would be against conscience for a group of men, acting under the cloak of a legal fiction, to ignore obligations undertaken by them in another capacity. There may be such an identity in a particular case, but as the probability is against it, the court is not justified in assuming such identity without proof. The primary purpose of the promoter is to interest investors in the proposed corporate enterprise. Almost invariably when the corporation is organized, persons not concerned in the projection are allottees of shares. Frequently the projector is not a member of the corporation at all. The injustice of the decision lies in subjecting innocent subscribers to obligations which they did not contemplate and which they cannot ascertain by reasonable diligence.[4]

If the theory advanced as to identity by Lord Cottingham be denied, it is difficult to find any ground for relief in equity, unless a contract be made out between the third person and the corporation, and such is apparently the view taken by the later decisions.[5]

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[1] *Supra*, p. 99, note 3.

[2] *In re* Skegness & St. Leonards Tramways Co., 41 Ch. D. 215.

[3] Fry, Specific Performance of Contracts, 4th ed., 103; Caledonian & Dumbartonshire Ry. Co. *v.* Magistrates of Helensburg, 2 Macq. H. L. Cas. 391; Preston *v.* L. M. Ry. Co., 5 H. L. Cas. 605; Kelner *v.* Baxter, L. R. 2 C. P. 174; Melhado *et al. v.* Porto Alegre, N. H. & B. Ry. Co., L. R. 9 C. P. 503; *In re* Empress Engineering Co., 16 Ch. D. 125.

[4] C. & D. Ry. Co. *v.* Magistrates of Helensburg, *supra;* Preston *v.* L. M. Ry. Co., *supra;* Earl of Shrewsbury *v.* N. Staffordshire Ry. Co., L. R. 1 Eq. 593.

[5] Gooday *v.* Colchester, etc., Ry. Co., 17 Beav. 132; Caledonian & D. Ry. Co.

The same conclusions are reached in cases[1] where the third person is attempting to prove in the winding-up proceedings of the corporation. In these cases the corporation had after organization passed resolutions or taken other steps for the purpose of adopting or ratifying the contract made on its account,—a circumstance not present in the cases decided by Lord Cottingham,—yet the right to prove was denied.

In the case of *In re* Northumberland Hotel Co.,[1] the directors of the company not only adopted the contract made by the promoter on its account, but took possession of leasehold premises obtained under the contract, compromised a suit for specific performance brought by the lessor, and paid rent to him, yet the lessor was not allowed to prove on the contract in the winding up proceedings, on the ground that no contract was shown to subsist between the lessor and the corporation. It is admitted by the court that if the lessor could have shown a new contract entered into between the corporation and himself, proof would have been allowed, but evidence that the directors passed resolutions adopting the agreement and took possession of property under it will not establish such a contract, since all those steps were obviously taken by the company under the assumption that the old contract was valid, and cannot be taken as showing a new contract.

In Scott *v.* Lord Ebury,[2] where the action was to recover from the promoters for money advanced by the plaintiffs to meet the parliamentary expenses incurred in securing the charter of the company, Willes, J., in reply to the contention that the debiting of the company by the plaintiff on its books, coupled with a resolution of the board of directors of the company confirming the agreement made by the promoters, showed a new contract which would discharge the promoter, observed that one element was lacking to make such a conclusion possible, namely, the assent of the bank. The acts urged as showing a new contract were taken in the mistaken belief of liability under the original contract, and there is no evidence of any meeting or agreement between the bank and the corporation.

Precisely what evidence will justify the conclusion that a new

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v. Magistrates of Helensburg, 2 Macq. H. L. Cas. 391; Preston *v.* L. M. Ry. Co., 5 H. L. Cas. 605.

[1] *In re* Empress Engineering Co., 16 Ch. D. 125; *In re* Northumberland Hotel Co., 33 Ch. D. 16; Kelner *v.* Baxter, L. R. 2 C. P. 174 (*semble*); Bogat Pneumatic Tyre Co. *v.* Clipper Pneumatic Tyre Co., 71 L. J. Ch. 158 (*semble*).

[2] L. R. 2 C. P. 254.

contract has been made is indicated in the case of Howard *v.* Patent Ivory Co.,[1] where one Jordan entered into an agreement with one Wyber, acting on behalf of the defendant company about to be formed, to sell certain property to the corporation. The corporation was organized, both the articles and memorandum providing for the adoption of the agreement in question. At a meeting of the directors, at which Jordan was present, resolutions were passed adopting the agreement and accepting the offer of Jordan to take part of the purchase price in debentures, and under the resolution the company's seal was affixed to the documents transferring a leasehold to the company and the debentures to Jordan. The company entered into possession of the leasehold premises and transacted business thereon. Subsequently the company was wound up, and the liquidator took an assignment of the rest of the property to be transferred under the agreement by Jordan to the company.

The court found on these facts that a new contract was entered into. The conclusion of the court in *In re* Northumberland Hotel Co.[2] was criticised but distinguished from the case at bar, on the ground that Jordan was present at the directors' meetings and participated in a modification of the original contract, in effect making a new contract.

It is questionable whether Edwards *v.* Grand Junction Ry. Co.[3] would be followed by the English courts[4] even if the precise question were involved. It certainly has been thoroughly discredited on principle, and the view now taken is that the corporation is not liable on contracts antedating its formation, although made on its account, but that the corporation may become liable on a new contract made directly between the corporation and the other party. In determining whether or not such contract exists, steps taken by either party in the belief that the original agreement made through the promoter still exists will not be considered. The proposition just stated, of course, excludes the exceptions previously referred to, where the liability rests on some principle of trust, novation, assignment, or express provisions of statute or charter.

The American cases, both at law and in equity, are overwhelmingly in favor of holding the corporation liable on contract antedating its existence, wherever it has "ratified or adopted" the

[1] 38 Ch. D. 156. [2] *Supra.* [3] *Supra.*
[4] Fry, Specific Performance of Contracts 107.

same, ratification or adoption being shown either by express resolution of the managing body or by accepting the benefits or fruits of the contract.[1]

The American cases without exception are subsequent in time to the group of cases decided by Lord Cottingham[2] which are cited with approval as decisive of the questions decided by the American courts, and apparently form the basis of the generally accepted American doctrine. No case has been found, however, that goes as far as the English cases referred to, the American courts insisting in every instance on some act by the corporation subsequent to organization showing an intent to be bound.

The American courts, owing, perhaps, to the obliteration of distinctions between law and equity in matters of procedure, have failed to note the limitations which the circumstances of the English cases impose upon them as general legal propositions. The principles underlying the liability imposed are as a rule very meagerly discussed; the liability is assumed rather than justified. The criticisms of Lord Cottingham's view by the later English cases are not noticed by the American courts, although in a few instances the arguments urged against their soundness are dealt with.[3]

A number of cases come within the exceptional classes noted in discussing the English decisions where the liability properly rests on a novation or assignment.[4]

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[1] Little Rock & Ft. Smith Ry. Co. *v.* Perry, 37 Ark. 164; M. & H. Hardware Co. *v.* Towers Hardware Co., 87 Ala. 206 (*semble*); Arapahoe Investment Co. *v.* Platt, 5 Colo. App. 515; Carter *v.* San Francisco Sugar Ref. Co., 19 Cal. 220; Stanton *v.* N. Y., etc., Ry. Co., 59 Conn. 272; The Georgia Co. *v.* Castlebury, 43 Ga. 187 (*semble*); Smith *v.* Parker, 148 Ind. 127; Dubuque Female College *v.* Township of Dubuque, 13 Iowa 555; Bank of Forest *v.* Argill Bros. & Co., 34 So. Rep. 325 (Miss.); Esper *v.* Muller, 91 N. W. Rep. 613 (Mich.) (*semble*); Grape Sugar & Vinegar Mfg. Co. *v.* Small, 40 Md. 395; Oaks *v.* C. W. Co., 143 N. Y. 430; Law *v.* Railway Co., 45 N. H. 370; Schreyer *v.* Turner Flouring Co., 29 Ore. 1; Bell Gap Ry. Co. *v.* Christy, 79 Pa. St. 54; Ireland *v.* Globe Milling Co., 20 R. I. 190 (*semble*); Huron Printing & Binding Co. *v.* Kittleson, 4 So. Dak. 520; Chase *v.* Redfield Creamery Co., 12 So. Dak. 529; Kaeppler *v.* Redfield Creamery Co., 81 N. W. Rep. 907 (So. Dak.); Pittsburg, etc., Mining Co. *v.* Quentrell, 91 Tenn. 693; McDonough *v.* Bank of Houston, 34 Tex. 309; Buffington *v.* Bordon *et al.*, 80 Wis. 635; Whitney *v.* Wyman, 101 U. S. 392 (*semble*).

[2] Edwards *v.* Grand Junction Ry. Co., Stanley *v.* Chester & B. Ry. Co., Webb *v.* L. & P. Ry. Co., *supra.*

[3] N. Y., etc., Ry. Co. *v.* Ketchum, 27 Conn. 170; Safety Deposit Life Ins. Co. *v.* Smith, 65 Ill. 309; Park *v.* Modern Woodmen of America, 181 Ill. 214; Oldham *v.* Mount Sterling Imp. Co., 103 Ky. 529.

[4] Colo. L. & W. Co. *v.* Adams, 5 Colo. App. 190; Stanton *v.* N. Y., etc., Ry. Co, 59 Conn. 272 (*semble*); Oldham *v.* Mount Sterling Imp. Co., 103 Ky. 529; Esper *v.* Miller, 91 N. W. 613 (Mich.) (*semble*); Snow *v.* Thompson Oil Co., 59 Pa. St. 209 (*semble*).

The view that a corporation may be estopped to deny that it is bound by the contract made by the promoter is advanced by a well known writer on corporations,[1] and is accepted as the basis of decision by a few courts.[2] The application of the principle is not clear, since the action of the corporation in approving the contract made on its account and in taking possession under it is attributable ordinarily to the belief shared by both parties that the original contract is binding upon them. How, then, is it possible to estop the corporation by conduct obviously due to a mutual mistake as to the legal liabilities of the parties?

In a number of jurisdictions the agreement between the promoter and third person is regarded as an open offer to the corporation, which it may accept when organized, and thus create a new contract between the third person and the corporation.[3] A resolution adopting or ratifying the original agreement, or the acceptance of the fruits of the contract is generally regarded as sufficient proof of acceptance.

It is evident that practically all of the cases decided on the ground of ratification or adoption could rest on the grounds stated in the cases just referred to, since in every instance the corporation has assented to the agreement made on its account, either in terms or by implication.

Both the English and American decisions recognize the possibility of a new contract between the corporation when organized and the third person, the broad line of distinction between the cases being the manner in which such contract can be made out; the English courts taking the position that acts of the corporation which are clearly attributable to the erroneous belief on its part that it is liable on the original contract cannot be received as evidence of a new contract, particularly when coupled with the further fact that direct negotiations between the third party and the corporation cannot be shown. The American courts, on the other hand, receive as evidence of a new contract all acts indicating an intent by the corporation to receive the benefits of the original contract.

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[1] Thompson, 1 Commentaries on Corporations, § 480.

[2] Blood *v.* La Serena Land & Water Co., 121 Cal. 221; Grape Sugar & Vinegar Mfg. Co. *v.* Small, 40 Md. 390 (*semble*).

[3] Smith *v.* Parker, 148 Ind. 127; Penn. M. Co. *v.* Hapgood, 141 Mass. 145 (*semble*); Holyoke Envelope Co. *v.* U. S. Envelope Co., 182 Mass. 171 (*semble*); Waetherford, etc., Ry. Co. *v.* Granger, 86 Tex. 350; E. & C. Oil Co. *v.* Burks, 39 S. W. Rep. 966 (Tex.); Wall *v.* Niagara Mining & Smelting Co., 20 Utah 474; Pratt *v.* Oshkosh Match Co., 89 Wis. 406.

The Supreme Court of Massachusetts approaches most nearly the present English view,[1] when it declares that a corporation cannot become liable on its promoters' contract by ratification or adoption. In a later decision,[2] the court, by way of *dictum*, intimates that the acceptance of benefits may be evidence of a new contract between the third party and the corporation.

The American decisions, while practically unanimous in the result reached, are far from satisfactory as to the legal principles underlying the liability. The English cases, on the other hand, have developed a logical, consistent theory of liability. The consequences of the liberal American view on the question of proof are not unjust: the corporation is protected against improvident agreements made on its account by promoters, since it has the power of acceptance or refusal. It is submitted that an equally just result is possible without doing violence to recognized principles of agency and contract.

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[1] Abbott *et al. v.* Hapgood *et al.*, 150 Mass. 248.

[2] Holyoke Envelope Co. *v.* U. S. Envelope Co., 182 Mass. 171.